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THE ACCOUNTANT'S RELATION TO TIMBER BOND ISSUES

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The position of an expert accountant in connection with timber bond issues differs radically from that of the cruiser, appraiser and attorney, inasmuch as his duties are, or should be, continuous; not only is he responsible for the accuracy of the balance sheet on which the bond issue is based, but he is a continuous protection to the bondholders.

All properly drawn trust deeds now provide for the appointment of auditors and for the submission periodically of audited statements to the trustees; the auditor therefore becomes the "watchdog"—it is his duty to report if the security is not at all times adequate and intact, in accordance with the terms of the mortgage and the provisions of the sinking fund.

It is doubtful whether sufficient importance is attached to that portion of the prospectus which deals with the expert accountant's report, or whether the general public realizes, when such report is omitted, the seriousness and significance of such omission. The expert accountant in these days is not merely an individual with an aptitude for figures. In addition to his knowledge of accounting principles, he must have sound business judgment and must bring to bear on his subject an expert knowledge of the particular business upon which he is reporting. Mere figures and statistics without that expert knowledge would be of little value.

On the above mentioned lines the duties of an auditor may, therefore, be considered under the following headings:

1. The security behind the bond issue.
2. The protection of the security for the bonds and the proper fulfillment of the trust deed.

The Security Behind the Bond Issue

The prospective investor is naturally primarily interested in the sufficiency of the assets securing the bond issue; he must be satisfied

that not only does the security offered afford adequate protection to his capital, but that the earning capacity is sufficient to provide for interest on the issue at all times. Most prospectuses contain reports from cruisers as to the value and extent of the holdings, from appraisers as to the value and condition of the plant and machinery and from expert accountants as to the general financial condition and earning capacity of the company in question. It must be borne in mind that the expert accountant's report is not compiled altogether separately and individually. It is not merely a collection of figures, for he must work hand in glove with his fellow experts and the final result should show the position of the company as determined by the combined experience and knowledge of all the experts engaged.

Consideration of the accountant's relation to particular items in the prospectus may be more intelligently set forth by a study of the details and figures submitted by the bond house or bank promoting the issue. The form varies in particular cases, but the following may be taken as a fair example of the facts and figures usually given in the case of the larger issues of bonds when the company is a "going concern."

X Y Z LUMBER COMPANY
FINANCIAL STATEMENT

ASSETS.

Capital Assets:

Timber lands and contracts, 848,590,848 feet at \$2.50 per 1,000 feet.....	\$2,121,477.12
Buildings, machinery and equipment, logging railroads and equipment, town site, mill site, etc.....	1,100,000.00
	\$3,221,477.12

Current Assets:

Cash in bank and on hand.....	\$8,257.60
Accounts receivable (less reserve for estimated freight and for doubtful accounts).....	162,400.25
Inventories.....	587,221.10
	757,878.95
Insurance paid in advance.....	826.80
	\$3,980,182.87

LIABILITIES.

Current Liabilities:

Notes payable.....	\$826,206.15
Accounts payable.....	42,620.18
	<hr/>
	\$868,826.43
Capital stock and surplus.....	3,111,356.53
	<hr/>
	\$3,980,182.87
	<hr/>

The first item for consideration is the timber holdings. It may be claimed that the auditor is not responsible for the accuracy of the cruise. No more is he; save when the cruise is carried out under his supervision, and it may be said that the firm with which the writer is associated has attached to its staff cruisers and other timber experts so as to enable it to substantially guarantee the reliability of any prospectus to which its name is attached. Assuming, however, that the timber has been cruised and valued separately, the bondholder may imagine that the report of this cruise is amply sufficient for his purpose. This is by no means the case. It is the auditor's duty to ascertain that the titles to the land or the licenses are actually in the name of the company and that they have been properly acquired and registered. He should also satisfy himself that the cruise is a reasonable one. This he can do if he is connected with an office that makes a specialty of the timber business, as there will no doubt be on file details of other cruises from the same district. He should thus be able to tell approximately what a given acreage should produce in the way of standing timber in a particular locality. Cases have been known where the cruise has shown standing timber which could not possibly have been crowded into the acreage owned by the company, and instances are not infrequent where timber not actually owned by the concern in question has been cruised and reported as part of the security.

It is cases like these that bring out the value of an accountant's services in connection with bond issues. The bond houses dealing in timber securities naturally try to safeguard their interests and the interests of the bondholders, but without an examination by reputable expert accountants it is almost impossible to afford adequate protection.

In some cases a specific value is attached to the land itself and an

estimate given of its probable worth after it has been cut over. All that can be said of these figures is that they are estimates pure and simple—the value of “cut over” lands is wholly problematical and is dependent on geographical and other conditions. If such a valuation is included the accountant must see that the lands are of course actually owned and that the estimate of their value is in his opinion a reasonable one. Conservative bond houses, however, it may be said, do not include the value of lands not cut over as part of the value of the security; the timber itself is usually the security for the issue and provides the sinking fund for the redemption of the bonds.

The next item with which the expert accountant must concern himself is the value placed on the plant, machinery and other equipment of the company. This has in all probability been separately appraised, but even in such a case he must be satisfied as to the reasonableness of the appraisal. Does it represent the actual value to the bondholder, is a vital question. The accountant must satisfy himself that this is the case; that the figures given represent an actual value and not a “reproduction” estimate, which has not necessarily any relation to actual value. The accountant has before him the details of the actual cost of construction, and, after providing for adequate depreciation based on the probable length of the “cut,” can ascertain whether the appraised value is approximately the actual one. The value of the plant and equipment of a lumber manufacturing concern is almost entirely dependent on the amount of timber available for its use and not upon its actual cost or “reproduction” value. Once the timber resources of the locality become exhausted, the plant and machinery are worth only their salvage value.

The current assets are not as a rule covered by the mortgage, but as the success of the business is dependent on the amount of floating as well as fixed capital, the accountant over whose name a financial statement is issued will naturally verify them, paying particular attention to the state of the accounts receivable, and the method of taking and pricing the inventory. He should ascertain by the production of the actual policies that the insurable property is adequately covered against loss by fire. He will also take steps to see that all known liabilities are included.

In addition to reporting on the assets, the accountant should investigate the earnings of the company and state what they have been for the past few years, after allowing for all ascertainable losses

and depreciation. Even though a company has assets valuable in themselves, they are poor security for an issue of bonds unless they can be profitably brought to market. Although past operations are not always a true index to future earnings, especially should a change of management have taken place, or a large extension of business be made possible through the introduction of new capital, the intending investor is entitled to full information in respect to them, so that he may form his own opinion as to their application to the future business of the company.

The investing public would do well to inquire very carefully into any proposition not reported on by expert accountants and should take steps to discover why such a very natural precaution has been omitted.

Protection of the Security for the Bonds and the Proper Fulfillment of the Trust Deed

The accountant's duties in connection with an issue of bonds should not cease when the bonds are subscribed for; his value to the bondholder is practically only commencing, for an auditor should be appointed to safeguard the interests of the bondholders during the life of the bonds. It is usually the only means whereby an investor can obtain an independent report as regards the condition of his capital invested in the company. Periodical and audited statements submitted to the trustees disclose the true position of the company, and enable them to act as the situation requires.

The provisions of trust deeds regarding statements of earnings and matters of a like character, are at times very inadequate, in some instances the company being only required to report the mill "run" monthly. Beyond disclosing the amount of timber used, such information is valueless from an accounting or economic standpoint. However, reputable bond houses usually provide for the insertion of an "audit" clause in all trust deeds, and the investing public should insist on this provision for its own protection.

An adequate audit naturally benefits the stockholder as well as the bondholder, but it is more particularly with the interests of the latter that this article is concerned. Assuming then that the trust deed provides for an annual or semi-annual audit, what protection does the bondholder derive from such an examination?

Firstly, he is informed whether his security, after the sinking

fund has been adequately and properly provided for, is intact. The accountant ascertains from the books information as to whether any part of the property has been sold or otherwise disposed of, and if any portion has been realized, whether the proceeds have been properly turned over to the trustees in the interest of the bondholders. He satisfies himself that the plant has been properly maintained and that the necessary provision for depreciation has been made. He carefully examines and criticises in detail all additions to and appreciations of capital assets, and verifies that all amounts charged to lands and timber, machinery and equipment and other assets of a like nature, are reasonably and properly chargeable to such accounts. An auditor's position is a responsible one and he takes nothing for granted.

Probably the next matter in which the bondholder is vitally interested is that of the sinking fund and its requirements. In order that the accountant may have a clear understanding of the whole situation it is necessary for him to carefully peruse and have a thorough grasp of the provisions of the trust deed and all its requirements; more particularly must he be familiar with those portions relating to the sinking fund. Sinking funds are as a rule provided for on the basis of logs cut (log scale) which is the more common, or on the mill run (lumber scale). Each method has features which recommend it, but that based on the scale of the logs cut is probably the most equitable to all concerned. Whatever be the basis, it is the auditor's duty to see that the provisions have been duly carried out and the necessary amounts deposited with the trustees at the stated periods. The accuracy of the company's own monthly reports to the trustees should be verified from the logging and other records. A very substantial check may also be had on the amount of logs actually handled by the saw mill by means of the board measure produced, the percentage of "overrun" or "underrun" varying with the particular scale used and also with the dimensions of the logs handled.

The auditor having been satisfied in these most important particulars, the bondholder is then assured that either his security is intact or that he has received its proper equivalent in actual cash. The accountant's duties and responsibilities do not end there, however; he should also be instructed to investigate the profit and loss account of the company, and report to the trustees as to whether

it is earning the amount of its interest or not. In the latter case, or should the auditor report any unfavorable condition of the assets, it is for the trustees to take such action as they consider that the situation warrants, and the trust deed permits.

In connection with statements regarding earnings, there are several features which are probably unknown to persons not actually engaged in the lumber industry, with which the accountant must be familiar. He must carefully examine the logging and mill records and ascertain that all items which enter into the cost of manufacture have been properly included, for the estimated cost of manufacture is often a prominent part of the prospectus, and the trustees are naturally interested in knowing how closely the actual results coincide with the estimated results. Very carefully must the auditor watch the item of "estimated freight," a constant source of error, and must see that the proper amount is deducted from the sales in respect thereof.

Depreciation on the whole of the company's operating properties must be provided for on a correct basis. It is often left to the auditor to fix the rate of depreciation, but where this is not the case he must be satisfied that the amount set aside is fair and reasonable.

The list of stock on hand should be carefully examined and the book inventory compared with the physical inventory. With regard to the pricing of the lumber inventory, much divergence of opinion exists among lumbermen, and even accountants are by no means agreed as to the best basis of valuation. It is not within the scope of this article to discuss the various methods and their particular advantages. The auditor will usually adopt the method of pricing used by the particular mill, but he should state in his report what basis has been adopted, and in cases where the cost of production has not been used as the basis for pricing the inventory, should give details showing the variation between the inventory price and the actual cost of manufacture.

All of the accounts receivable must be carefully scrutinized and the accountant must be satisfied that the reserve set up is adequate to provide for probable loss in connection with unrealizable amounts.

The auditor must be also satisfied that all the known liabilities of the company, both actual and contingent, have been included.

The value of an expert accountant's services in connection with

the discovery and prevention of fraud are too widely known to be discussed at the present time, and are without the scope of this article, which is intended to show the benefits to be derived from examinations made by expert accountants in connection with timber bonds and in relation to audits carried out after the bond issue is completed. The majority of promotions are honest, but neither the trustees for the bondholders, nor the bondholders themselves should be content to rely upon the unsupported statements of the officials of the company. Generally speaking, the statements are honestly made and without fraudulent intent, but the officials, having to rely largely on the work of their subordinates, at times render statements which are misleading if not wholly inaccurate.

The appointment of auditors under deeds of trust is becoming more and more general, as the investing public and the bond houses realize that examinations are necessary to protect the interests of the bondholders, not only at the commencement of the issue, but during the life of the bonds.